

# United States Senate

WASHINGTON, DC 20510

December 7, 2007

The Honorable Ben Bernanke  
Chairman  
Board of Governors of the  
Federal Reserve System  
20<sup>th</sup> and Constitution Avenue, NW  
Washington, DC 20551

Dear Chairman Bernanke:

In light of the deepening crisis in the mortgage markets, a crisis you correctly attribute to abusive practices and lax underwriting standards in the subprime market, we want to reiterate to you the importance of acting forcefully to protect consumers in the rulemaking the Federal Reserve Board is currently undertaking under the Home Owners Equity Protection Act (HOEPA) of 1994.

In your testimony before the Joint Economic Committee (November 8, 2007), you note that the subprime mortgage crisis has triggered significant "turmoil" in the financial markets that has affected other parts of the mortgage market. In fact, it is clear from your testimony and other statements that the problems caused by abuses in the subprime market are creating a significant drag on the economy as a whole. For that reason, and because of the central role homeownership has played in the creation of wealth for working Americans, we want to urge you and your colleagues on the Board to include four critical components in the regulation as you prepare to issue the regulation.

1. The regulation should establish a clear ability-to-pay standard for subprime and nontraditional loans. Nothing goes to the heart of the current problem in the market more than the abandonment of this central principle. A borrower's ability to pay should be based on a loan's fully-indexed rate, assuming full amortization of the loan. If a loan has a negative amortization feature, that must be fully considered in determining a borrower's ability to pay. In determining ability-to-pay, the Board should consider residual income and the total debt-to-income (DTI) ratio for the borrower. As you know, any DTI that is greater than 50 percent has the potential to create serious affordability problems for the borrower.

Most subprime loans made over the last several years, of which only about ten percent of which were made to first-time homebuyers, have been so-called "exploding" adjustable rate mortgages (ARMs) – loans that have relatively affordable teaser rates that grow quickly beyond many borrowers' ability to make the required payments. In a recent presentation to shareholders, for example, Countrywide disclosed that 89 percent of the Pay Option ARMs it originated in 2006 and 83% of those originated in 2005 would not meet the standards of the sensible guidelines put out by the federal regulators. These

loans were abusive to individual borrowers well before house price appreciation slowed or reversed because, fundamentally, these loans were not made on the basis of a borrower's ability to pay. This is, in effect, asset-based lending - a practice HOEPA was fundamentally designed to prevent. The Federal Reserve Board and other federal regulators failed to act in a timely fashion to prevent this crisis from occurring. It must now act decisively to ensure it does not happen again.

2. The regulation should require escrow accounts for taxes and insurance for subprime loans and designate the failure to do so as an unfair or deceptive practice. Such escrows are nearly universal in the prime market. It is quite clear from testimony received by the Committee that the failure to escrow for taxes and insurance is another practice that puts homeowners at risk. In fact, it appears that subprime lenders and brokers seem to routinely quote monthly payments to prospective borrowers that do not include taxes and insurance as a way of deceiving the borrowers into thinking that their monthly obligations will be lower than their true costs and their current payments.

Moreover, failing to provide a subprime borrower with an escrow account for taxes and insurance often leads to financial difficulties for the borrower when these payments come due, thereby creating an opportunity for the originator to "flip" the borrower into another loan, generating a new set of fees for the originator while stripping thousands of dollars of equity out of the home.

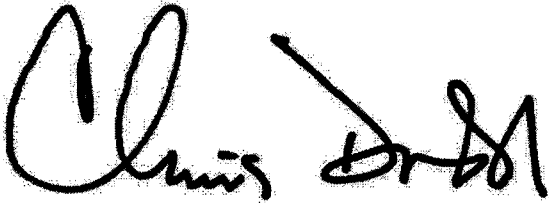
3. The regulation must constrain the use of no- and low-documentation mortgages. The use of these loans has skyrocketed over the past several years, even though many subprime borrowers are willing and able to document their income. Often, brokers and lenders simply sell these loans to borrowers because they are faster and easier to originate, and they are compensated more for them by investors. Unfortunately, this often results in borrowers being sold higher-rate, adjustable-rate mortgages when they could have qualified for a 30-year fixed-rate mortgage at lower interest rates. Again, this is a practice that may benefit the originator, but puts the homeowner at grave risk.
4. Finally, the regulation should prohibit prepayment penalties for subprime mortgages. Again, we must note that prepayment penalties are extremely rare in the more transparent and competitive prime market whereas they are nearly universal in the far more opaque subprime market. Compared to only 2 percent of prime loans, roughly 70 percent of subprime loans have prepayment penalties. In the subprime market, prepayment penalties protect investors from brokers and other originators who "upsell" subprime borrowers, usually in return for yield spread premiums. Because these borrowers are sold loans that are more expensive than those for which these borrowers could qualify, they become obvious candidates for refinance loans. Certain investors demand prepayment penalties to protect their returns, at the cost of trapping borrowers in higher-cost loans.

Moreover, there is substantial research that indicates that prepayment penalties in the subprime market do not result in lower interest rates. This should not be a particular surprise, given the difficulty of doing any comparison shopping in the subprime market.

Eliminating prepayment penalties will help reduce one of the most damaging features of subprime loans and help protect the home equity of subprime borrowers.

We appreciate the fact that the Board is moving forward with a rulemaking under HOEPA, and expect the Board to meet the duty Congress entrusted to it to end the abusive practices in the subprime market that have undermined confidence in the subprime mortgage market with serious consequences for the capital markets and the economy as a whole. Thank you, once again, for your consideration of our views.

Sincerely,



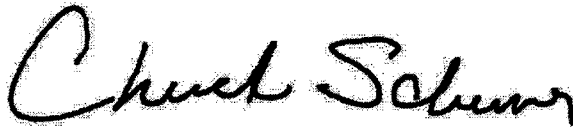
Senator Christopher J. Dodd



Senator Tim Johnson



Senator Jack Reed



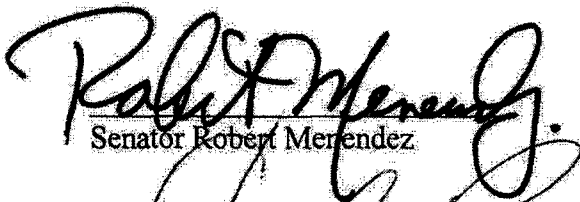
Senator Charles E. Schumer



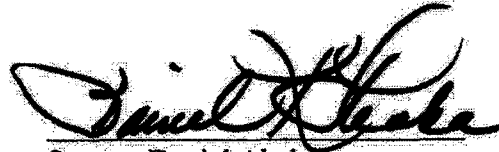
Senator Evan Bayh



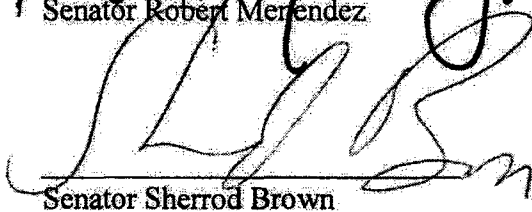
Senator Thomas R. Carper



Senator Robert Menendez



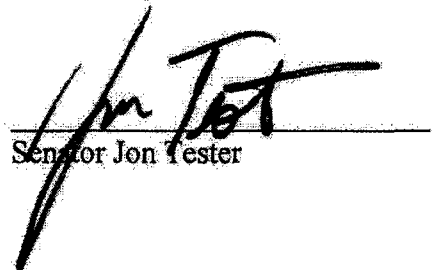
Senator Daniel Akaka



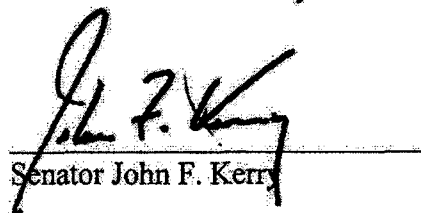
Senator Sherrod Brown



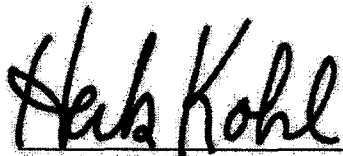
Senator Robert P. Casey



Senator Jon Tester



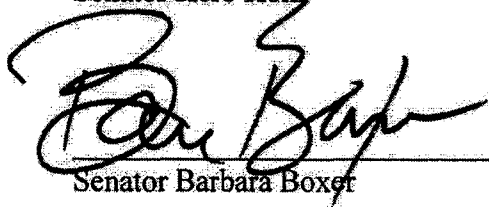
Senator John F. Kerry

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Senator Herb Kohl

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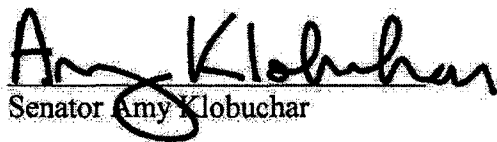
Senator Russ Feingold

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Senator Barbara Boxer

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Senator Frank R. Lautenberg

Handwritten signature of Amy Klobuchar in black ink.

Senator Amy Klobuchar